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September 22, 1997

*Via Facsimile: (303) 231-3385
and Regular Mail*

Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165, MS 3021
Denver, Colorado 80225-0165

Re: **MMS Notice: "Amendments to Gas Valuation Regulations for Federal Leases"**
62 FR 19536 (April 22, 1997)

Dear Mr. Guzy:

In the April 22, 1997 Federal Register, Minerals Management Service (MMS) issued a notice withdrawing its previously proposed rulemaking for valuing natural gas produced from Federal leases. MMS also requested comments on specific alternative or any other alternatives industry may recommend to simplify the gas valuation process while maintaining revenue neutrality. Marathon Oil Company (Marathon) welcomes the opportunity to offer the following comments on this issue.

FEDERAL GAS VALUATION NEGOTIATED RULEMAKING COMMITTEE (REGNEG)

MMS, States, and industry, including Marathon, devoted considerable time and expense during the REGNEG process and Marathon is disappointed that the strong commitment of all the respective parties has not resulted in a valuation methodology that the MMS can endorse. Current gas valuation regulations are extremely complex to comply with in relation to today's marketing trends and have historically resulted in an increase of litigation.

MMS REASONS FOR WITHDRAWAL OF PROPOSED GAS VALUATION REGULATIONS

In its notice, the MMS states that the gas market is undergoing dramatic change and therefore cites this as a reason for withdrawing the REGNEG proposal. The MMS seems to have lost sight of the fact that royalty value is due at the lease. The ever changing market is actually occurring downstream of the wellhead at various pools and market centers removed from the lease. MMS, by moving their valuation point away from the lease, is effectively establishing a new market standard which violates applicable statutes and lease terms. Marathon agrees with, and even encourages, the MMS to promulgate gas valuation regulations that will both simplify and add certainty for all parties. However, in order to do so, we must find a way to value the gas at some indices in close proximity of the lease not hundreds of miles away from the field or area where

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it is produced. The published indices such as Inside FERC and Natural Gas Daily are valid representation of the market value of gas at or near the lease and are the most accurate point at which to calculate wellhead netbacks.

Additionally, the MMS references a cost benefit analysis which indicated a loss in revenue of approximately \$20 million annually as a further reason to abandon REGNEG. After reviewing the summary of MMS' analysis, it is obvious that the MMS has made many false assumptions in calculating the alleged shortfall. MMS gave equal weight to each index published price without any consideration for the actual gas sold and/or transporting through each specific system. MMS also failed to eliminate anomalies ie; POP contract sales, dedicated high price contracts, and prices which are escalated by gas contract settlement incremental values.

COMMENTS ON TWO NEWLY PROPOSED OPTIONS

Although the option of a plus/minus (X) factor added to some published indices may provide certainly, it does not provide simplicity. If the MMS, by its own admission, cannot calculate a timely safety net then how can they propose to calculate a plus/minus factor within such limited time frame? Since the X factor which the MMS would calculate represents a combined entity of sampled gross proceeds from various companies, numerous market centers, and varying quality of production it would be questionable at best; not to mention the short time frame in which the MMS would restrict themselves for auditing the necessary gross proceeds information. MMS and industry alike have repeatedly acknowledged that gross proceeds under the existing regulation are near impossible to trace. The X option does nothing to alleviate this problem since it still requires compliance with the existing gross proceeds valuation. It is also logical to assume and expect that each year the MMS would elect to sample different properties thereby requiring industry to maintain all existing support for gross proceeds on all of their properties. The MMS purports to alleviate the need for transportation allowance information since the X factor will take care of transportation adjustment. However since we have no advance notice of which properties will be used in their gross proceeds audit we would still be burdened with all of the administrative and subjective interpretation that has caused the existing gas valuation and transportation allowance problems for both MMS and industry.

The second option which the MMS suggests is based upon royalty collection practices currently used by the Norwegian Government. Although the basic concepts of the Norway Petroleum Pricing Board may be fundamentally sound in Norway's limited capacity, in actual practice it would be nearly impossible to implement for U.S. federal onshore gas leases. The demographics and complexities of onshore federal gas marketing arrangements can include transportation through more than 25 intra/interstate pipelines to multiple pools and/or commingling points. These complexities would severely impede the ability of any board to determine a mutually agreed upon wellhead price.

OTHER ALTERNATIVES

To no avail, the MMS and industry have spent over ten years attempting to achieve a gas valuation regulations that industry could reasonably comply with and MMS could accurately audit. The most practical alternative by industry always seem to circle back to the MMS taking their royalty in kind (RIK). Both industry and the MMS realize that we must work together to effectively resolve the gas valuation problems. Marathon, however, remains somewhat skeptical that this will happen given the historical background:

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- January 1982 - Linowes Commission concluded that 85% of all royalty underpayments are caused by improper valuation and recommended the Department of Interior issue detailed guidance on product valuation.
- February 1987 - Notice of Proposed Rulemaking published on gas valuation.
- April 1987 - In public hearings and written comments, industry was united in their assertion that the proposed gas regulations, as written, were impossible to comply with and the MMS should consider a gas RIK program.
- March 1988 - Current gas valuation regulations were published in final form.
- November 1988 - MMS industry questionnaire "Selected Options for Change in the Royalty Management Mission" responses again encouraged the MMS to implement a gas RIK program as a means of resolving or obviating royalty valuation disputes.
- September 1989 - Royalty Management Advisory Committee (RMAC), discusses gas RIK. Although in the report they acknowledge that it would alleviate auditing and valuations problems, the panel rejected the proposition because the government would have to execute and administer contracts, track production to final disposition, arrange for storage, negotiate transportation agreements and administer balancing agreements which would create added burdens and operational costs to the government. [Even with this acknowledgment of the added costs, the MMS continues to expect the lessee to incur these downstream costs without granting allowances from royalty.]
- June 1991 - Compliance Task Force report proposed that the MMS undertake clarification of regulations and policies for fair, reasonable, and enforceable value determination.
- December 1991 - Proposed rule to amend gas valuation benchmarks published. [Final benchmark rule never published.]
- February 1992 - Committee on Interior and Insular Affairs came to the conclusion that gas valuation and allowances "remain widely misunderstood"; and subsequently issued their oversight report which states "...the revised regulations, finally published in 1988, have done little to clarify the valuation issues..."
- May 1994 - Royalty Gas Marketing Pilot - A limited pilot program was conducted for the entire 1995 calendar year. The September 1996 Final Report indicated an operational success, but concluded that royalties collected were less than in value royalties.
- June 1994 - Federal Gas Valuation Negotiated Rulemaking Committee formed for gas valuation.
- November 1995 - Proposed gas valuation rule published.
- April 1997 - Proposed gas valuation rule withdrawn.

Given the failure historically to effectively resolve the gas valuation problems and the MMS' apparent continued pursuit of added value from downstream activities, Marathon urges the MMS to genuinely pursue implementation of a RIK program as a cost-effective alternative. This will

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avoid confronting the issue in the judicial arena, in addition to eliminating the need for the lessee to contend with valuation issues. If kept simple, this alternative could dramatically reduce the administrative burden placed on both the federal lessees and the MMS.

If you have any questions, please contact me.

Sincerely,

A handwritten signature in cursive script that reads "Dow L. Campbell".

Dow L. Campbell

[82636]